



## Investment Letter – Q4 2015

“Get off zero and get off quick...Near-term pain? Yes. Long-term gain? Almost certainly. Get off zero now!”  
Bill Gross, Influential Fixed Income Investor

At the end of each year, as market activity begins to wind down, we hold our annual Investment Conference to analyse the events of the year just past and to debate our thoughts on the next. When discussing the major market moments of 2015, it was clear that we continue to favour some of our longest-held positions. We continue to avoid the traditional fixed income markets which we do not believe provide the same income and security that they have in the past. We have not invested into commodity markets. We remain cautious in the US. Within the UK, our preference for small and mid-caps stocks performed well over the year, particularly when compared to the commodity-heavy FTSE 100. Our significant exposure to Japan continued to generate positive returns while our considerable exposure to absolute return strategies has protected capital through difficult and volatile markets. 2015 was challenging when compared to the benign markets we have seen over recent years, but our decisions on asset allocation and the performance of the managers we have selected helped us to deliver good results.

Looking back at the year as a whole, however, most traditional asset classes have suffered at some point. Commodities were the hardest hit, with oil in particular impacted by massive oversupply, leading to reports that a number of countries had run out of oil storage space onshore. A two-mile long flotilla of stationary oil tankers, full of crude, between the Middle-East and the US was a stark symbol of the unyielding global supply glut – and provided evidence that the price of oil may have further to fall. While lower commodity prices have positive benefits for consumers, the fall in prices demonstrates the lack of demand from the global economy. In general, commodity prices do not drive economic growth: economic growth drives commodity prices.

Since 2009, credit (debt issued by governments and companies) has been the big winner, with the availability of cheap debt creating a substantial bubble. As interest rates have tested generational lows, the prices of fixed income assets have soared and the issuance of new credit has increased dramatically. The expansion in credit markets leading up to the global financial crisis of 2008 was largely fuelled by bank debt; in contrast, today's bubble has expanded rapidly as companies around the world looked to take advantage of artificially low interest rates. In every credit cycle, higher interest rates end up punishing financial excess, and in 2015 we started to see the beginning of this in a number of areas. High-yield bonds, (debt issued by companies with lower credit ratings) have had a torrid year, with debt issued by energy companies at the epicentre as the world began to understand how important collapsing oil prices are to global finance. That said, the underperformance of high yield compared to investment grade bonds at least indicates that better quality companies are finally being rewarded for their improving creditworthiness while less well managed companies struggle. This positive sign is offset by increasing concerns over liquidity in the bond markets. The combination of a plentiful supply of money to the markets following quantitative easing (QE), low trading volume following regulatory pressures on banks, and record bond issuance has created new pressures in markets. The selloffs this year in fixed income assets across the credit quality spectrum have highlighted these pressures. It has been relatively easy to issue debt to income-hungry investors since the 2008 financial crisis. But when the tide turns and investors attempt hastily to close positions, it could feel like a large crowd trying to fit through a very small door.

For equity markets, the start of 2015 passed without too much trouble as markets rallied strongly. Fears over a Greek exit from the European Union provided the first bout of volatility and by August, markets were trading wildly as investors balked at the shock currency devaluation by the People's Bank of China. The concern was not how far the market moved, but how much it was moving and actually going nowhere at all: despite little change in the overall direction of travel, record intra-day swings became the norm. The good times appeared to be long in the tooth with concerns surrounding a potential interest rate rise in the US exacting their toll. Driven by QE, asset prices had been diverging from economic fundamentals for too long. Following the selloff over the summer, the fourth quarter saw European equity markets recover much of the ground lost, giving them a positive return on the year as a whole. Asian markets performed similarly with a general recovery into year end, with even Chinese equity markets seeing some relief from their troubles. Japanese policy makers disappointed by holding back on further stimulus in the fourth quarter; however, the wider Japanese markets did still manage to return more than 10% in sterling terms over the year. Emerging markets were less positive, with some fluctuating up and down over 10% intra-quarter, as worries over a deeper slowdown in these regions lingered. In our letter at the end of 2014 we wrote of the demise of the 'Nifty Fifty', a group of 50 large US companies that were credited with leading the buoyant equity market of the early 1970s. In 2015, their contemporaries now consist of a small group of explosively rising



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stocks, described by some as the Five Horsemen of the Apocalypse: Facebook, Amazon, Microsoft, Netflix and Google. At the turn of 2015, the combined market capitalisation of these companies totalled \$1.1 trillion, with combined earnings of \$246 billion. As the year drew to a close, the Horsemen were valued at over \$1.6 trillion: a market capitalisation gain of over 45%, even as their combined earnings for the year increased by only 15%. While the strong performance of these companies, and that of similar growth stocks in other developed markets, makes the overall equity market look healthy, it masks the less impressive returns of the broader equity market. We do feel these stocks have become overvalued, and are considerably more comfortable in our diversified positioning in value stocks.

As the year drew to a close, it was this backdrop that set the scene for central bankers in Europe and the US, when all eyes turned once more to the European Central Bank (ECB) and the Federal Reserve (Fed) and their December decisions on interest rates. Mario Draghi disappointed, failing to provide the market with the support that many had been expecting. While the ECB cut its deposit rate and extended the length of QE, it crucially held off on expanding the size of it. Fixed income, equity and currency markets in Europe and Asia floundered on the back of this surprise, viewed by many as too weak a commitment to driving inflation in Europe. As markets fluctuated, the Federal Open Market Committee (FOMC) had to make its decision over whether to raise interest rates in the US for the first time in 10 years. The Fed's flip-flop in September, following clear signs that they would in fact go ahead with the raise before backing off entirely, caused considerable market confusion as investors interpreted their reticence as a lack of confidence in the economy. But with some positive economic data in the US, their decision to hike this time was almost inevitable. The FOMC finally heeded the call from Bill Gross and other influential investors to raise interest rates, starting the process of normalisation and giving themselves the ability to cut rates again in the face of any future economic weakness. What was surprising to some was the language they used that implied an increased pace of further rate hikes next year, suggesting four interest rate rises in 2016. But the Fed's hike still leaves US rates at very low levels, and recent history is littered with examples of central banks making an early rate rise then having to do an about face.

Looking ahead to 2016, with a potential EU referendum on the cards in the UK and a US election in November as the Fed looks to continue to bed in further interest rate rises, we do not expect plain sailing. Rising rates and lacklustre growth are ultimately not a great combination for asset prices. But our defensive positioning has shown its ability to protect capital during downturns and perform during upswings. A correction in some asset classes feels overdue; at which point we have the ability to rotate our asset allocation to reflect a more optimistic outlook.

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